

BEFORE THE
STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

New Landing Utility, Inc.	:	
Proposed general increase	:	ICC Docket No. 04-0610
in water and sewer rates	:	

Direct Testimony of
Scott J. Rubin

on Behalf of
the People of the State of Illinois
by the Office of Attorney General

AG Exhibit 4

January 21, 2005

1 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

2 A. My name is Scott J. Rubin. My business address is 3 Lost Creek Drive, Selinsgrove, PA.

3 Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

4 A. I am an independent consultant and an attorney. My practice is limited to matters
5 affecting the public utility industry.

6 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS CASE?

7 A. I have been asked by the Office of Attorney General to review the quality of service
8 provided by New Landing Utility, Inc. (NLU or Company), evaluate the fitness and
9 overall quality of the utility's management and operations, and make a recommendation
10 concerning the appropriate method to reflect these issues in this rate case.

11 Q. WHAT ARE YOUR QUALIFICATIONS TO PROVIDE THIS TESTIMONY IN THIS CASE?

12 A. I have testified as an expert witness before utility commissions or courts in the District of
13 Columbia and in the states of Arizona, Delaware, Kentucky, Illinois, Maine, Maryland,
14 New Jersey, New York, Ohio, Pennsylvania, and West Virginia. I also have testified as
15 an expert witness before two committees of the U.S. House of Representatives and one
16 committee of the Pennsylvania House of Representatives. I also have served as a
17 consultant to several national utility trade associations and to state and local governments
18 throughout the country. Prior to establishing my own consulting and law practice, I was
19 employed by the Pennsylvania Office of Consumer Advocate (OCA) from 1983 through
20 January 1994 in increasingly responsible positions. From 1990 until I left the OCA, I was
21 one of two senior attorneys in that Office. Among my other responsibilities in that
22 position, I had a major role in setting the OCA's policy positions on water and electric

1 matters. In addition, I was responsible for supervising the technical staff of that Office. I
2 also testified as an expert witness for that Office on water rate design and cost of service
3 issues.

4 Throughout my career, I developed substantial expertise in matters relating to the
5 economic regulation of public utilities. I have published articles, contributed to books,
6 written speeches, and delivered numerous presentations, on both the national and state
7 level, relating to regulatory issues. I have attended numerous continuing education
8 courses involving the utility industry. I also periodically participate as a faculty member
9 in utility-related educational programs for the Institute for Public Utilities at Michigan
10 State University, the American Water Works Association, and the Pennsylvania Bar
11 Institute. Appendix A to this testimony is my curriculum vitae.

12 Q. HAVE YOU PREVIOUSLY TESTIFIED AS AN EXPERT WITNESS IN CASES INVOLVING
13 RELATIVELY SMALL WATER AND WASTEWATER UTILITIES?

14 A. Yes, during the past ten years, I have analyzed numerous rate increase requests from
15 relatively small water and wastewater utilities in New Jersey. When required, I have
16 submitted testimony in such cases. Appendix A lists and briefly describes the cases
17 where I have submitted testimony. In addition to the New Jersey cases shown in the
18 Appendix, I would estimate that I have provided similar services in that State in at least
19 20 other water and wastewater utility cases that were resolved through stipulations prior
20 to the filing of testimony.

21 In addition, I have served as a consultant and expert witness in several small
22 utility cases in Pennsylvania and for several small municipally owned utilities in New
23 England. I also have testified before the Delaware Public Service Commission in a case

1 involving a relatively small utility's alleged failure to provide adequate and reliable
2 service to its customers.

3 Q. JUST TO BE CLEAR, WHEN YOU SAY THAT YOU HAVE DONE WORK INVOLVING "SMALL"
4 WATER UTILITIES, WHAT DO YOU MEAN BY "SMALL"?

5 A. The definition of a "small" water utility varies. Under the federal Safe Drinking Water
6 Act, for most purposes a small utility serves fewer than 3,300 people or about 1,000
7 customer connections. For some purposes, a utility might be considered "small" if it
8 serves up to 10,000 people, or about 3,300 customer connections. When I say that I have
9 testified in cases involving small water and wastewater utilities, I am referring to utilities
10 that have had as few as 100 customers and perhaps as many as 5,000 customers. When I
11 discuss research that I have conducted involving small utilities, that typically would
12 involve research that examines different sizes of small utilities, such as those serving
13 fewer than 500 people, fewer than 3,300 people, and fewer than 10,000 people.

14 According to NLU's Annual Report for 2003, it has 309 active water customers,
15 156 active wastewater customers, and 695 availability customers. Whatever definition is
16 used, there is no question that NLU is a small water and wastewater utility. I am very
17 familiar with utilities of this size.

18 Q. OTHER THAN YOUR TESTIMONY AS AN EXPERT WITNESS, DO YOU HAVE ANY OTHER
19 PROFESSIONAL EXPERIENCE INVOLVING SMALL WATER UTILITIES THAT IS RELEVANT TO
20 THIS CASE?

21 A. Yes. For much of my career, I have been studying the special needs and problems of
22 small water utilities. In the early 1990s, I served as a member of the Small Water
23 Systems Advisory Committee in Pennsylvania. In 1992, I published my first research

1 study in this area, concerning methods of assessing the viability of small water systems.
2 Throughout the 1990s, I continued to work in this field. I was a member of project teams
3 that conducted work under contract for the Pennsylvania Department of Environmental
4 Resources and the Texas Natural Resource Conservation Commission concerning
5 methods to assess and improve the capabilities of small water systems.

6 In 2000 and 2001, I served as part of a team that developed an in-depth training
7 program for the American Water Works Association (AWWA). The program, called the
8 Capacity Assistance Program, trains water industry professionals to help small water
9 utilities assess their strengths and weaknesses and identify specific ways to improve the
10 quality and reliability of their service. An article summarizing some of this work, entitled
11 “Ten Practices of Highly Effective Water Utilities,” was published in 2001. This article
12 was recently reprinted in *Water and Wastes Digest*. A copy of the article is attached to
13 this testimony as Schedule SJR-1.

14 I also have conducted several research studies concerning specific issues affecting
15 small utilities for the National Rural Water Association (NRWA) and the American
16 Water Works Association Research Foundation.

17 The results of my work in this area have been presented at national meetings of
18 the National Association of Regulatory Utility Commissioners (NARUC), the National
19 Association of State Utility Consumer Advocates, AWWA, and others. I also have
20 lectured at NARUC’s Annual Regulatory Studies Program at Michigan State University
21 on issues related to the regulation of small water utilities.

1 Q. PLEASE SUMMARIZE YOUR UNDERSTANDING OF THIS CASE.

2 A. NLU filed a request for a rate increase in September 2004. That case essentially was a
3 re-filing of a rate case that had been dismissed earlier in 2004 because of NLU's failure
4 to provide information concerning various contracts and relationships with affiliated
5 individuals and companies.

6 The rate request seeks to increase rates for water and wastewater service by
7 approximately \$407,000 (244%). This would mark the first rate increase for NLU in
8 more than 20 years. During the intervening years, according to NLU's balance sheet, the
9 Company has sustained a cumulative loss in excess of \$1.2 million.

10 Q. ARE THERE ANY RELATED CASES OR OTHER CONCERNS THAT AFFECT YOUR REVIEW OF THIS
11 CASE?

12 A. Yes. I have been apprised of litigation brought by the State of Illinois against NLU,
13 alleging various violations of drinking water and clean water statutes and regulations.
14 *People of the State of Illinois v. New Landing Utility, Inc. and Gene Armstrong*, Circuit
15 Court for Ogle County, Illinois, No. 00-CH-97, which I will refer to as *People v. NLU*. I
16 have reviewed many of the documents from that litigation, including the court's order
17 that finds in favor of the State on most counts, notes numerous deficiencies in NLU's
18 operations, and directs NLU to make certain improvements to its facilities and operations.
19 A copy of the court's order is attached as Schedule SJR-2.

20 I am also aware of complaints from NLU's customers that have been lodged with
21 the Commission and the Office of Attorney General. These complaints provide an
22 important indication that the deficiencies in NLU's facilities and operations, as found by

the court in *People v. NLU*, are having a direct impact on the quality of service received by NLU's customers.

Q. HOW DID YOU CONDUCT YOUR REVIEW OF NLU?

A. I relied on documents provided by the Company in its filing and during discovery, the evidentiary record and court order from *People v. NLU*, petitions from NLU's customers, and photographs of NLU's facilities provided by the Illinois Environmental Protection Agency (IEPA).

Q. WHAT STANDARDS OR CRITERIA WILL YOU USE TO ASSESS THE ADEQUACY OF WATER SERVICE PROVIDED BY NLU?

A. The Illinois statutes require public utilities to "furnish, provide, and maintain such service, instrumentalities, equipment, and facilities as shall promote the safety, health, comfort, and convenience of its patrons, employees, and public and as shall be in all respects adequate, efficient, just, and reasonable." § 220 ILCS 5/8-101. In addition, the statutes require a public utility to "provide service and facilities which are in all respects adequate, efficient, reliable and environmentally safe" § 220 ILCS 5/8-401. While the language differs from state to state, the standard in Illinois is very similar to what I have seen in other jurisdictions – a utility must provide safe, adequate, and reliable service to the public.

Q. HOW DO YOU DETERMINE WHETHER A WATER UTILITY IS PROVIDING "ADEQUATE, EFFICIENT, AND RELIABLE" SERVICE?

A. To assess the adequacy of service provided by a water utility, I use a standard that I believe represents the expectations of reasonable customers: **Is the water service**

1 **suitable for use for normal, household purposes?** This standard requires the utility to
2 provide water service that is continuous in nature; has adequate pressure; complies with
3 microbiological and chemical standards for safety; does not have serious taste and odor
4 problems; and does not cause damage or discoloration to customers' plumbing fixtures,
5 appliances, or laundry. As I discuss below, the "household use" standard has been used
6 in several other states as a reasonable way of implementing the "adequate, efficient, and
7 reliable service" standard for a water utility.

8 Q. WHY DOES IT MAKE SENSE TO HAVE AN "ADEQUACY" STANDARD THAT GOES BEYOND
9 PUBLIC HEALTH?

10 A. The provision of utility service essentially involves a contract between the utility and
11 consumers. Each party enters the relationship with certain expectations. The utility
12 expects to receive a reasonable return on its investment, as well as the recovery of its
13 expenses. The consumer expects to have the service available when it is needed and in a
14 way that is useful.

15 Almost 20 years ago, the Pennsylvania Public Utility Commission expressed
16 these concepts quite well, when it stated:

17 It is our opinion that in exchange for the utility's provision of safe,
18 adequate, and reasonable service, the ratepayers are obligated to pay rates
19 which cover the cost of service which includes reasonable operation and
20 maintenance expenses, depreciation, taxes and a fair rate of return to the
21 utility's investors. Thus, as the OCA contends, a quid pro quo relationship
22 exists between the utility and its ratepayers. In return for providing safe
23 and adequate service, the utility is entitled to recover, through rates, these
24 enumerated costs. We find this principle to be consistent with the
25 standards enunciated in *Federal Power Commission v. Hope Natural Gas*
26 *Co.*, 320 U.S. 591 (1944) wherein it was stated that the "... fixing of just
27 and reasonable rates involves a balancing of the investor and the consumer
28 interest. ..."

1 In reaching a determination as to whether a utility has provided
2 adequate and reasonable service, we note that every customer is entitled to
3 water that is fit for the basic, domestic purposes (e.g., cooking, drinking,
4 washing and bathing). Although a few isolated or sporadic instances or
5 complaints of water received by customers [n8] that is unfit for the
6 aforementioned basic, domestic purposes would not warrant a finding that
7 a utility has failed in its provision of adequate and reasonable service, we
8 believe that probative evidence in a particular case showing a significant
9 failure on the part of a utility to provide adequate and reasonable service
10 would provide a basis for a conclusion that a utility has provided
11 inadequate service. Finally, we point out that customers are entitled to
12 adequate and reasonable service at the time they are paying their bills, not
13 some optimistic point in the future.

14 [n8] We emphasize received by customers because we believe that
15 the water should be usable for domestic purposes when it comes out of the
16 customer's tap. For example, if the water is fit for domestic purposes when
17 in the reservoir but is unfit after it passes through old distribution mains,
18 the water is unfit.

19 *Pa. Public Utility Commission v. Pa. Gas and Water Co.*, 61 Pa. PUC 409, 74 PUR 4th
20 238 (1986) (emphasis added).

21 Q. OTHER THAN THE PENNSYLVANIA COMMISSION, ARE YOU AWARE OF OTHER STATE
22 COMMISSIONS THAT HAVE FOUND WATER QUALITY PROBLEMS TO RESULT IN THE PROVISION
23 OF INADEQUATE SERVICE BY A WATER UTILITY?

24 A. Yes, I am. I have not conducted exhaustive research in this area, and I have not updated
25 the research in several years, but I am aware of decisions from California, Delaware,
26 Maryland, New Hampshire, and Washington where commissions have found that water
27 quality problems can constitute the provision of inadequate water service by a water
28 utility.¹

¹ *Citizens Utilities Company of Cal.*, 48 CPUC 2d 664 (1993); *Tidewater Utilities Inc.*, PSC Complaint Docket No. 309-97, 1998 Del. PSC LEXIS 182 (Aug. 11, 1998); *Utilities Inc. of Maryland*, 82 Md. PSC 66 (1991); *Great Bay Water Co., Inc.*, 80 N.H. PUC 233 (1995); *Alderton-McMillin Water System, Inc.*, 146 PUR 4th 372 (Wash. UTC 1993).

1 Q. FROM THE INFORMATION THAT YOU HAVE SEEN, IS NLU PROVIDING WATER SERVICE THAT
2 IS SUITABLE FOR ALL HOUSEHOLD PURPOSES?

3 A. From the information that I have seen, it does not appear that NLU is providing service to
4 its customers that is suitable for all household purposes, or that is otherwise consistent
5 with its obligation to provide safe and reliable service. NLU's customers have
6 experienced extended outages, repeated bouts of very low water pressure, dirty or
7 discolored water, damaged fixtures and appliances, and several other problems.

8 Q. CAN YOU BE MORE SPECIFIC CONCERNING THE COMPLAINTS OF NLU'S CUSTOMERS?

9 A. Yes. I have attached as Schedule SJR-3 the sworn testimony of five NLU customers in
10 *People v. NLU*. All of the testimony was given in January 2004. It represents, therefore,
11 the quality of service provided by NLU to its customers during the test year in this rate
12 case. To the best of my knowledge, there has not been any significant change in the
13 quality, safety, and reliability of service provided by NLU to its customers during the
14 year since this testimony was given.

15 The testimony from NLU's customers establishes that there have been numerous
16 water outages, line breaks, and boil water advisories.² Shockingly, the customers report
17 that there have been outages that lasted two or three days.³

18 In addition, the customers uniformly complain of rock, sand, and sediment in the
19 water lines.⁴ This has caused significant inconvenience and damage to consumers'
20 appliances and plumbing fixtures, including repeated damage to hot water heaters,

² Mr. Olliges, Jan. 6, 2004, pp. 187-88; Mr. Kersten, Jan. 7, 2004, p. 8; Ms. Fane, Jan. 9, 2004, pp. 139 and 141; Ms. Valdivieso, Jan. 9, 2004, pp. 148 and 150-51.

³ Ms. Fane, Jan. 9, 2004, p. 139; Ms. Valdivieso, Jan. 9, 2004, p. 151.

⁴ Mr. Olliges, Jan. 6, 2004, p. 188; Mr. Kersten, Jan. 7, 2004, p. 8; Ms. Sharp, Jan. 7, 2004, pp. 107-10; Ms. Fane, Jan. 9, 2004, pp. 140 and 144; Ms. Valdivieso, Jan. 9, 2004, pp. 151-52.

dishwashers, and other appliances;⁵ inability to do laundry;⁶ very low water pressure;⁷ a malfunctioning water meter;⁸ cloudy water, dirty water, and water with sediment in it;⁹ clogged faucets;¹⁰ among others.

Q. HAS THE COMPANY INDICATED WHETHER THESE PROBLEMS ARE WIDESPREAD?

A. Yes. NLU acknowledges that its service in the Lost Nation Subdivision is substandard and has frequent problems with sediment in the lines. In response to Staff Data Request CLH-2, NLU states:

These old water lines [in the Lost Nation Subdivision] contain sediments that constantly jam water meters, thus making it impossible to measure the amount of water used. For most of these customers, the meter readings reflect zero usage from one reading to the next reading. Replacement of jammed water meters is usually of no avail, as the replacement meter is very quickly jammed by the prevailing conditions. Because of these unreadable meters, NLU's "water sold" figure is unavoidably lower than actual usage. NLU estimates that the figures are understated by at least one third because of the 101 homes that are connected to the old lines in Lost Nation Subdivision.

Thus, NLU acknowledges that it is providing water that is so laden with sediment that it clogs water meters. This confirms the problems to which NLU's customers testified in *People v. NLU*, and confirms that the problem affects 101 of its 309 (at year-end 2003) active water customers.

⁵ Mr. Olliges, Jan. 6, 2004, pp. 188-89; Ms. Sharp, Jan. 7, 2004, pp. 107 and 109-10; Ms. Fane, Jan. 9, 2004, p. 140.

⁶ Ms. Sharp, Jan. 7, 2004, pp. 111

⁷ Ms. Sharp, Jan. 7, 2004, pp. 108-09; Ms. Fane, Jan. 9, 2004, p. 139; Ms. Valdivieso, Jan. 9, 2004, p. 150

⁸ Ms. Fane, Jan. 9, 2004, p. 144

⁹ Ms. Sharp, Jan. 7, 2004, pp. 112; Ms. Valdivieso, Jan. 9, 2004, pp. 150-52

¹⁰ Mr. Kersten, Jan. 7, 2004, p. 8; Ms. Sharp, Jan. 7, 2004, pp. 107-08

1 Q. DOES THE INFORMATION YOU REVIEWED PROVIDE ANY LIKELY REASONS FOR THESE
2 PROBLEMS?

3 A. Yes. It is very apparent that these problems are the result of many years of neglect and
4 mismanagement of the utility. IEPA inspection reports for at least the last ten years show
5 repeated violations of important public health and operational standards. These
6 violations include the failure to conduct required water quality testing; failure to have a
7 cross-connection control program (which ensures that unlicensed water sources and/or
8 sewage discharges cannot be inadvertently connected to the water supply system); failure
9 to maintain adequate pressure; failure to properly operate and maintain facilities,
10 including the failure to adequately maintain the utility's water tower; failure to flush the
11 system of accumulated debris and sediment; failure to have a certified operator in charge
12 of the operations of the water system; among others.

13 Similarly, inspection reports from the Illinois Commerce Commission in 2004
14 show numerous deficiencies, including the failure to maintain records; failure to inspect
15 and test water meters; failure to vent the chlorine tank; failure to properly maintain
16 facilities; failure to flush water lines; failure to have a backup source of water; among
17 others. I have attached as Schedule SJR-4 a copy of letters from the Commission to NLU
18 dated June 15, 2004, and August 5, 2004. According to NLU's December 10, 2004,
19 response to Data Request AG 4.2 (a copy of which is attached as Schedule SJR-5), NLU
20 has not taken any action in response to these deficiency letters from the Commission.

1 Q. IN THE PARAGRAPH THAT YOU QUOTED ABOVE FROM NLU'S RESPONSE TO STAFF DATA
2 REQUEST CLH-2, NLU STATES THAT ITS INABILITY TO METER MORE THAN 100 OF ITS
3 CUSTOMERS IS "UNAVOIDABLE." DO YOU AGREE WITH THAT CHARACTERIZATION?

4 A. No, I certainly do not. Far from being unavoidable, the problem would be corrected if
5 NLU properly operated and maintained its facilities. Accumulating sediment can be
6 remedied by regularly flushing the distribution system, installing screens at the source of
7 supply, and replacing cracked or undersized distribution mains. Despite repeated
8 complaints from its customers, and repeated deficiency notices from IEPA and the ICC,
9 the Company has not taken any actions to remedy this very serious problem.

10 Q. IS NLU'S MANAGEMENT SHOWING SIGNS THAT IT UNDERSTANDS THE SEVERITY OF THESE
11 DEFICIENCIES AND THAT IT WILL TAKE REASONABLE ACTIONS TO PROVIDE THE SAFE AND
12 RELIABLE SERVICE IT IS REQUIRED TO PROVIDE TO THE PUBLIC?

13 A. No, it is not. NLU's management continues to deny responsibility for the Lost Nation
14 portion of its service area that has old, under-sized water mains. NLU states that it has no
15 plans to finance any repairs or improvements to the system and that it does not believe it
16 could raise capital for such repairs or improvements (responses to AG 4.3, AG 4.25, Staff
17 FD-8, and Staff FD-9).

18 Q. IS NLU'S FAILURE TO PROVIDE SAFE AND RELIABLE SERVICE THE RESULT OF INADEQUATE
19 REVENUES?

20 A. No, I don't think so. Instead of investing in its utility system, it appears that NLU instead
21 has spent exorbitant amounts of money on legal fees (paid primarily to the owner of
22 NLU) and on questionable fees paid to the owner's relatives. From 2001 through 2003,
23 NLU spent over \$390,000 on legal fees (response to AG 4.17). From 2000 through 2004,

1 NLU paid the owner's wife and son almost \$35,000 for some administrative and
2 bookkeeping services, including a rental fee for storage space of records (response to AG
3 4.7). If these funds had been invested in NLU's facilities and operations, NLU could
4 have remedied many of the deficiencies identified in the inspection reports and made
5 tremendous steps toward providing its customers with safe and reliable service.

6 Q. ARE YOU SAYING THAT NLU DOES NOT REQUIRE A RATE INCREASE AT THIS TIME?

7 A. I have not analyzed NLU's current revenues, expenses, and rate base. That analysis has
8 been undertaken for the Office of the Attorney General by Mr. Effron, excluding any
9 consideration of quality of service issues. His analysis shows that NLU's revenues are
10 sufficient to pay the reasonable costs of operation, and even provide a small return on rate
11 base, meaning that the utility could pay its investors a return on their investment,
12 although at a lower level than is available to other utilities. Further, I believe that
13 historically NLU would have had adequate revenues to remedy many of its problems if it
14 had chosen to spend its resources on its system instead of on its owner, his family, and
15 imprudent legal fees.

16 Q. CAN YOU BE MORE SPECIFIC ABOUT THIS?

17 A. Yes, I have prepared Schedule SJR-6 to illustrate this point for the period 2000 through
18 2003. On the schedule, I show NLU's net income in each year, as taken from its annual
19 reports to the Commission. I also show the amount that NLU paid primarily to its owner
20 and his family for management fees, contract services, and rent. Finally, I also show the
21 amount collected in each year for depreciation expense which, while it is a real expense
22 from an accounting standpoint, does not represent a cash outlay. The final column on the
23 schedule shows the calculation of funds that would have been available for investment in

1 the NLU system but for the payments to NLU's owner and his family. This represents
2 the sum of net income, owner payments, and depreciation expense. As it shows on the
3 schedule, the total for the four years is in excess of \$83,000.

4 Q. HAS NLU MADE ANY SIGNIFICANT INVESTMENT IN ITS UTILITY SYSTEM DURING THE PAST
5 SEVERAL YEARS?

6 A. No, it has not. The simplest way to illustrate this is by comparing the level of net plant in
7 service over time. For most utilities, and certainly for a properly operated water utility, I
8 would expect the level of net plant in service to grow over time. This occurs naturally as
9 facilities are replaced and upgraded, as well as through any expansion that may occur.
10 But even without expansion, I would expect normal replacement of capital equipment to
11 result in expenditures on new plant that exceed annual depreciation expense; thereby
12 resulting in an increase in net plant in service. (Net plant, of course, is gross plant in
13 service less accumulated depreciation.)

14 Schedule SJR-7 shows this comparison for the years 2000 through 2003, again
15 taken directly from NLU's annual reports to the Commission. The schedule shows that
16 NLU's net plant balance has been declining steadily each year. This means, simply, that
17 NLU has been failing to reinvest in its physical plant. Indeed, in each year the plant
18 balance is declining by an amount roughly equal to the annual depreciation expense.
19 This means that NLU has been investing nothing in new plant and equipment – not even
20 the amount it recovers through rates for depreciation expense.

21 To further illustrate the extent of this problem, I also have included data from
22 1994 and 1995 (from the annual reports for those years), to show that this same trend has
23 been occurring for at least the past decade. The net plant balance at year-end 2003 is

1 more than \$200,000 lower than the balance at year-end 1994. With annual depreciation
2 expense in the range of \$20,000, this demonstrates that NLU essentially has invested
3 nothing in its utility system for at least ten years.

4 Q. NLU CLAIMS THAT IT IS NOT RESPONSIBLE FOR UPGRADING FACILITIES IN THE OLD PORTION
5 OF THE DEVELOPMENT, KNOWN AS LOST NATION, THAT WERE INSTALLED BY A DIFFERENT
6 ENTITY. IS IT REASONABLE TO HOLD THE COMPANY RESPONSIBLE FOR SERVICE
7 DEFICIENCIES THAT RESULT FROM FACILITIES INSTALLED BY SOMEONE ELSE?

8 A. Yes, it is. In 1973, NLU applied for a certificate of public convenience from the
9 Commission. The Commission's Order granting the certificate (a copy of which is
10 included as Schedule SJR-8) specifically recognizes that the Lost Nation development is
11 part of the certificated service area for NLU. Thus, the Commission states: "One area of
12 the development, referred to as Lost Nation (except Section 9 thereof) was part of a
13 previous real estate venture by another developer. A water system was installed in that
14 area at the inception of that development" Schedule SJR-8, pages 2-3. While the
15 Commission exempted Lost Nation customers from paying an availability charge, the
16 Commission did nothing to affect NLU's obligations to provide safe and reliable service
17 in that area.

18 In fact, the order granting NLU's certificate clearly places an obligation on NLU
19 to "construct, operate and maintain a water supply and distribution system" in its service
20 area. Id., pages 3, 4, and 5. That service area includes the Lost Nation development.
21 Moreover, the Commission granted the certificate with the "express condition and
22 provision that authority and permission to use the lands to be occupied shall be secured
23 from the landowners and/or public authorities as and where required by law" Id.,

1 page 6.

2 In short, NLU's certificate of public convenience covers the Lost Nation
3 development; requires NLU to construct, operate, and maintain adequate facilities
4 throughout its service area; and obligates NLU to obtain whatever property rights are
5 necessary in order for it to legally install, operate, and maintain its facilities. I do not find
6 any merit, therefore, in NLU's argument that it does not have any responsibility for the
7 old facilities in Lost Nation. On the contrary, it appears to me that NLU's certificate of
8 public convenience squarely places the responsibility for those facilities on NLU and
9 requires NLU to operate and maintain (and repair and replace) those facilities. If NLU
10 claims that it lacks ownership of those facilities, or otherwise does not have the right to
11 repair or replace them, then NLU would be in direct violation of a condition of its
12 certificate that required it to obtain the property rights needed for its operations.

13 I also would note that the Circuit Court in *People v. NLU*, similarly found that
14 regardless of the actual ownership of facilities, as the operator of the water system NLU
15 is responsible for proper maintenance, line flushing, sealing of inactive wells, elimination
16 of cross-connections, and other activities in its entire service area. Schedule SJR-2,
17 pp. 4-5 and 8.

18 Q. IN ADDITION TO QUALITY OF SERVICE ISSUES, DO YOU HAVE CONCERNS WITH THE QUALITY
19 OF NLU'S OPERATIONS AND MANAGEMENT?

20 A. Yes. As I noted above, NLU's management appears to be unresponsive to the serious
21 service deficiencies on its system. Many of those deficiencies have existed for ten years
22 or more. Further, I am concerned that NLU's management is allowing the utility's assets
23 to waste away. Preventive maintenance is not being performed, equipment is rusting and

1 not operational, sound operations and maintenance practices are not being followed, and
2 the utility has lost access to the capital markets.

3 Q. WHAT STANDARDS OR CRITERIA WILL YOU USE TO ASSESS THE OPERATIONS AND
4 MANAGEMENT OF NLU?

5 A. In assessing the adequacy of NLU's operations and management, I am guided by the
6 standards generally used to assess the fitness of a public utility to serve the public. Those
7 standards are grouped into three categories: Technical, Financial, and Managerial. While
8 they are inter-related, each category addresses a critically important part of utility
9 operations.

10 Technical fitness refers to the utility's knowledge and actions concerning
11 technical or engineering aspects of providing service. For a water utility this would
12 include knowledge of, and compliance with, regulations that govern the treatment,
13 production, and distribution of water; implementation of reasonable protocols for
14 maintaining facilities; having emergency plans, including a backup generator; and
15 generally ensuring that the facilities are well maintained and operated in a safe and
16 responsible manner.

17 Financial fitness refers to the utility's ability to manage the utility's funds. This
18 would include having in place reasonable accounting procedures; ensuring that the utility
19 maintains access to capital (through lines of credit, for example); keeping complete
20 financial records, including continuing property records; applying for changes in rates
21 when cash flows become inadequate to sustain continuing operations; and generally
22 ensuring that the utility remains a viable, going concern from a financial standpoint.

23 Managerial fitness encompasses the overall operations of the utility. Managerial

1 issues include the utility's planning process; customer service; interface with regulators;
2 oversight of contractors; labor relations; compliance with applicable laws and
3 regulations; and similar concerns.

4 Q. HOW DOES THE ARTICLE THAT YOU ATTACHED AS SCHEDULE SJR-1 RELATE TO THESE
5 STANDARDS?

6 A. The article discusses practices of what we termed "highly effective" water utilities. If a
7 utility were to do everything we discuss in that article, it certainly would surpass the
8 minimally acceptable levels of fitness that we expect of a small water utility. The
9 categories in the article, however, provide a good framework for assessing a utility's
10 operations. While it might exceed minimum expectations for a small utility to prepare
11 financial reports, shareholder reports, credit reports, technical inventory, and compliance
12 assessment (item 1 in the article), the category "Prepare Reports" is an important one. I
13 would expect a utility to prepare appropriate reports, both for itself and for regulators, so
14 that the utility and key stakeholders know how the utility is operating and whether it
15 faces any challenges that must be addressed.

16 Q. DOES NLU PREPARE APPROPRIATE REPORTS?

17 A. With the exception of reports that it is legally required to prepare (such as its annual
18 report to the Commission), it does not appear that NLU regularly prepares reports that
19 would help the utility, its investors, its customers, or its regulators understand its
20 operations.

21 Q. YOUR ARTICLE ALSO TALKS ABOUT MANAGING INFORMATION, FOLLOWING A BUDGET
22 PROCESS, PRACTICING SELF-ASSESSMENT, CONDUCTING AUDITS, PERFORMING STUDIES,

1 SEEKING REVENUE ENHANCEMENTS, SUBMITTING TO PEER REVIEW , PLANNING, AND
2 EXPLORING RESTRUCTURING. TO THE BEST OF YOUR KNOWLEDGE, DOES NLU ENGAGE IN
3 ANY OF THESE ACTIVITIES?

4 A. No. To the best of my knowledge, NLU does not do anything in any of these categories.
5 I would emphasize that each of these categories is an important group of actions that any
6 reasonably operated and managed utility should undertake with a reasonable degree of
7 frequency (for example, annual budgets, five-year strategic and business plan, etc.).
8 There is no indication that NLU has ever engaged in any of these critically important
9 activities.

10 Q. IN YOUR OPINION, DOES NLU HAVE THE REQUISITE TECHNICAL FITNESS TO OPERATE AS A
11 PUBLIC UTILITY?

12 A. No, it does not. As I mentioned above, NLU has had repeated violations of IEPA
13 regulations and standards. From January 1, 1994 through May 1, 2001, NLU did not hire
14 a licensed operator for its water facilities. The physical state of NLU's facilities is
15 substandard, to say the least. The water tank, pumps, chlorinator, and other equipment
16 are not being adequately and safely maintained. Required water quality tests were not
17 performed for more than seven years. In short, for an extended period of time, NLU
18 failed to hire or contract for personnel who have the technical knowledge necessary to
19 safely and reliably operate and maintain a water and wastewater utility.

20 A certified operator is trained, and passes a certification test, to demonstrate an
21 understanding of the operation of critical water system operations, such as proper
22 maintenance of facilities; operation of chlorinators and other treatment equipment; a
23 basic understanding of water chemistry, treatment, and engineering; and so on. A

1 certified operator should be responsible for the physical operations and maintenance of
2 any water or wastewater system. Aside from being a violation of law, this is the height of
3 irresponsibility to fail to have a certified operator involved in the operations of a water or
4 wastewater utility. Failure to have a certified operator jeopardized the public health and
5 safety, threatened the health of NLU's customers, and endangered the value of NLU's
6 physical assets. NLU's past failure to have a certified operator for its water operations
7 shows a lack of care that undermines confidence in NLU's ability and desire to properly
8 operate a public water supply.

9 Q. DO YOU HAVE SIMILAR CONCERNS ABOUT NLU'S TECHNICAL FITNESS TO OPERATE AS A
10 WASTEWATER UTILITY?

11 A. Yes, I do. NLU's wastewater operations suffer from problems that are very similar to the
12 problems with its water system. According to IEPA, deficiencies in the wastewater
13 operations include equipment that does not function and long-term neglect (such as the
14 failure to remove sludge from the facility) that results in NLU being out of compliance
15 with its wastewater discharge permit. The problems with the wastewater system pose a
16 danger to public health and safety and are likely to create serious odor problems, as well
17 as unlawful discharges of effluent. Perhaps most serious is the fact that these deficiencies
18 are very long term in nature, with many of them having gone uncorrected for 10 years or
19 more. In short, NLU's wastewater operations exhibit the same symptoms of either
20 ignorance or neglect that are exhibited in its water operations.

1 Q. IN YOUR OPINION, DOES NLU HAVE THE REQUISITE FINANCIAL FITNESS TO OPERATE AS A
2 PUBLIC UTILITY?

3 A. No, it does not. NLU has waited more than 20 years to file for a rate increase.
4 According to NLU's balance sheet, during that time period it has sustained losses totaling
5 more than \$1.2 million. Moreover, NLU has made some exceedingly poor decisions
6 about when and how to spend its money – spending tens of thousands of dollars on
7 attorneys, the owner and his family, but spending virtually nothing on its utility plant. As
8 a result of these very poor – indeed, irresponsible – decisions, NLU apparently has lost
9 whatever access it may have had to outside capital. NLU states that it does not believe
10 that it could find anyone to invest either debt or equity capital in the utility. Thus,
11 through the extraordinary requests it is making in this case, NLU is asking its customers
12 to become forced investors in the utility. This is not only unlawful (it is the utility's
13 obligation to raise and spend capital, while customers compensate the utility for the
14 return of and on capital; it is not the obligation of customers to provide the capital), it is
15 perhaps the strongest indication that NLU lacks sound financial management.

16 Q. IS IT REASONABLE TO EXPECT A UTILITY OF NLU'S SIZE TO MAINTAIN ACCESS TO CAPITAL?

17 A. Yes, it is. In fact, it is absolutely critical that a small utility maintain access to capital.
18 Typically, this is done through a relationship with a local bank that understands the
19 utility's importance to the community, is knowledgeable about the utility's cash flow and
20 operations, may process bill payments and payroll for the utility, and provides the utility
21 with a reasonable line of credit. That line of credit provides access to capital for routine
22 maintenance, repairs, capital additions, and small expansions. Part of a reasonable
23 financing plan also would include establishing a reserve fund for periodic, large

1 expenditures, such as tank painting which typically occurs every ten years and can cost
2 tens of thousands of dollars. Large projects, such as a major expansion, typically would
3 be funded through a combination of developer contributions and project-specific
4 financing.

5 Q. DOES NLU HAVE THIS TYPE OF ACCESS TO CAPITAL?

6 A. No, it does not. In fact, it does not appear that NLU has made any arrangements for
7 access to capital or to obtain any type of line of credit. This coupled with NLU's other
8 inadequate management practices has impeded NLU's ability to perform routine
9 maintenance and repairs, as well as its ability to plan for and implement necessary,
10 periodic maintenance (such as tank painting). Given the deteriorated condition of its
11 water tank, it is apparent that NLU has never had the tank painted or maintained in any
12 way – even though it is more than 25 years old. Typically, a water tank should be
13 inspected and painted at least every ten years.

14 Q. IN YOUR OPINION, DOES NLU HAVE THE REQUISITE MANAGERIAL FITNESS TO OPERATE AS A
15 PUBLIC UTILITY?

16 A. No, it does not. All of the problems that I have discussed – poor to non-existent
17 maintenance, wasting assets, failure to have a licensed operator, loss of access to capital,
18 failure to address long-standing deficiencies, and so on – all stem from the same problem:
19 management that is either inattentive or irresponsible. The owner and manager of the
20 utility either does not understand the obligations of a public water and wastewater utility,
21 or he has consciously chosen to ignore them. Either way, he is not fit to be in charge of
22 the day-to-day operations of a public utility.

1 Q. HOW DOES THE IEPA LITIGATION AGAINST NLU RELATE TO THE QUALITY OF NLU'S
2 MANAGEMENT?

3 A. It appears to me that the litigation was prompted by NLU's repeated failure to properly
4 operate, maintain, and manage the utility. The result has been multiple and repeated
5 violations of IEPA requirements and the provision of unsafe and inadequate service to
6 NLU's customers. In my opinion, it was imprudent for NLU's ownership and
7 management to allow the utility to deteriorate to such an extent. NLU then compounded
8 this imprudence by spending well in excess of \$100,000 on legal fees to contest the
9 litigation. Instead, a reasonable and prudent utility would have entered into a settlement
10 or consent decree and used those funds to undertake much-needed improvements in its
11 facilities and operations.

12 Q. ARE THERE OTHER INDICATIONS THAT NLU'S MANAGEMENT IS IRRESPONSIBLE?

13 A. Yes. In 1984, 100% of NLU's stock was sold by its previous owner to DAME Co. Such
14 a transaction, that involves a change in majority ownership, as well as management and
15 control, of a public utility requires prior approval from the ICC. § 220 ILCS 5/7-204.
16 NLU did not seek Commission approval in 1984, prior to or when it was purchased by
17 DAME Co., a company wholly owned by Gene Armstrong, who became the President of
18 NLU. Further, the ICC Staff informed NLU in 2004 that it had failed to seek
19 Commission approval of the transaction and suggested that NLU include a request for
20 approval when it refiled its rate request. Yet the Company has never sought ICC
21 approval for this transaction. There is a serious question, therefore, whether the current
22 ownership and management of NLU even has the lawful right to own and operate the
23 utility.

1 Q. WHY IS COMMISSION APPROVAL OF THIS TYPE OF TRANSACTION IMPORTANT?

2 A. Aside from the fact that the law requires Commission approval, it is important for the
3 Commission to review the fitness of a prospective owner, operator, and manager of a
4 public utility. Public utilities are different from other businesses. A public utility has an
5 exclusive right to provide the public with an essential service. It is critically important,
6 therefore, that the ICC evaluate the fitness of a prospective new owner of a public utility
7 to insure that the utility will have access to capital and the necessary expertise to provide
8 safe and reliable service to the public.

9 Moreover, the statute recognizes this important oversight responsibility, because
10 it requires the Commission to find that the new ownership “will not diminish the utility's
11 ability to provide adequate, reliable, efficient, safe and least-cost public utility service; ...
12 will not result in the unjustified subsidization of non-utility activities by the utility or its
13 customers; ... [will ensure that] costs and facilities are fairly and reasonably allocated
14 between utility and non-utility activities ...; [and] will not significantly impair the
15 utility's ability to raise necessary capital on reasonable terms or to maintain a reasonable
16 capital structure.” § 220 ILCS 5/7-204(b).

17 By failing to submit its change in ownership and control to the Commission, not
18 only has the ownership of NLU failed to comply with the law, but it has failed to submit
19 to a Commission review of its fitness to operate as a public utility. This provides yet a
20 further indication of the deficiencies in NLU's management.

1 Q. HOW DO YOU PROPOSE TO DEAL WITH THESE SERIOUS PROBLEMS AND HOW DO YOU
2 SUGGEST THE COMMISSION DECIDE THIS RATE CASE?

3 A. I recommend that the Commission deny NLU any rate increase at this time. The quality
4 of service that is currently being received by NLU's customers is not adequate and the
5 customers should not be required to pay any more for that substandard service than they
6 are currently paying. As Mr. Effron shows, NLU's existing rates are sufficient to recover
7 NLU's reasonable, on-going level of expenses and a positive return on its rate base. A
8 utility that provides poor service should not receive the return received by utilities that
9 provide adequate service. Current rates will allow NLU to continue to operate while its
10 technical, financial and management problems are addressed.

11 In addition, I strongly recommend that the Commission take whatever action is
12 necessary to bring professional management to this utility. It appears that the
13 Commission could accomplish this result by facilitating a change in ownership, seeking
14 the appointment of a receiver, revoking NLU's certificate of public convenience (or
15 finding that NLU is in violation of the conditions contained in that certificate), rejecting
16 the affiliated interest agreements with the owner, or some combination of these actions.
17 However it is accomplished, the Commission must do something to ensure that the
18 utility's assets stop wasting away and that capital is raised to correct the serious service
19 deficiencies and asset decay.

20 Once new management is in place and service begins to improve, then it would be
21 appropriate to re-evaluate the utility's rates. Unless and until there is proper management
22 and an improvement in service, however, the utility should not receive any increase in
23 rates. Indeed, given the owner's history of spending utility funds for legal fees (much of

1 which is paid to his firm) and his family, there is no certainty that any rate increase
2 granted by the Commission would be properly used to provide service to the public.

3 Q. WOULD THE DENIAL OF ANY RATE INCREASE JEOPARDIZE THE ABILITY OF NLU TO
4 CONTINUE TO OPERATE?

5 A. No, it would not. If NLU stops spending money imprudently, it would have sufficient
6 revenue to meet its operating expenses. In 2003, NLU's combined revenues from water
7 and wastewater operations were \$166,564. Its total combined expenses for operations,
8 maintenance, and taxes, excluding legal fees and management fees, were \$96,011. In
9 other words, NLU's present rates provide more than sufficient revenue for the utility to
10 continue operating and to even begin performing some of the long-deferred maintenance
11 and repairs.

12 Moreover, Mr. Effron's comprehensive analysis shows that NLU's existing rates
13 provide a return on rate base of \$10,243¹¹, over and above a reasonable, on-going level of
14 expenses. In addition, Mr. Effron shows annual depreciation expense of \$19,925. Under
15 its existing rates, therefore, NLU would have available at least \$30,168 per year to invest
16 in necessary repairs and maintenance.

17 Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

18 A. Yes, it does.

¹¹ Required return of \$36,176 less revenue deficiency under present rates of \$25,933 equals return under present rates of \$10,243.